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In the Supreme Court of the United States

OCTOBER TERM, 1944

No. 410

OWEN N. PRICE, TRUSTEE FOR BONDHOLDERS OF THE WESTERN TOOL & MANUFACTURING CO., ET AL., PETITIONERS

v.

JAMES G. GURNEY, INDIVIDUALLY AND ON BEHALF OF OTHER SHAREHOLDERS OF THE WESTERN TOOL & MANUFACTURING COMPANY, ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT

MEMORANDUM FOR THE SECURITIES AND EXCHANGE COMMISSION AMICUS CURIAE

1. *Introductory.*—The Securities and Exchange Commission, in the light of its statutory responsibilities in the administration of Chapter X of the Bankruptcy Act, presents this memorandum as *amicus curiae,* to express its views on the question of public importance presented in this case.[1] This

[1] The Commission did not participate in the reorganization proceeding in the district court or in the appeal in the court below.

question is whether under Chapter X stockholders may properly file a derivative petition for reorganization for and in the name of their corporation, upon allegations that reorganization is needed to preserve the stockholders' equity and that the board of directors has in bad faith failed and refused to institute such proceedings.

It is our position that Chapter X does not exclude exercise by the bankruptcy court of equitable jurisdiction to permit the filing of a stockholder's petition on behalf of his corporation where adequate showing is made that such action is necessary to protect the stockholders' equity from a clear breach of the fiduciary responsibilities owed by management. Clearly Chapter X does not give stockholders, as such, a direct or non-derivative right to institute proceedings.[2] However, we believe that a derivative right exists and that it can be adequately safeguarded against abuse by holding stockholders to the strict standards of the derivative action rule and by requiring a hearing, on notice to the corporation among others, before approval of the petition.

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[2] The specifications in the Act for the filing of voluntary petitions by the debtor, and involuntary petitions by creditors, clearly exclude the right of stockholders as such to file an involuntary petition. See the cases cited by petitioner (Br. p. 13). These cases do not seem pertinent to the question of the right to file a derivative petition.

We are aware of no authorities directly in point in the bankruptcy field,[3] but agree with the majority of the court below that since the Bankruptcy Act does not attempt to specify who shall act for the corporation in filing a petition, this is left to the applicable principles of general corporation law. Accordingly, we believe that the ordinary principles of the derivative action rule are applicable unless plainly inconsistent with the purposes or provisions of Chapter X.[4] With the safeguards

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[3] We do not regard the absence of precedents as negativing the possibility of a stockholder filing a derivative petition under Chapter X. Only under the reorganization sections of the Bankruptcy Act and then only if the corporation is merely unable to pay its debts as they mature, could a stockholder have a valid basis for filing a derivative petition. Since a petition based on insolvency in the bankruptcy sense concedes that stockholders have no equity, it is difficult to imagine a situation in which stockholders could claim an interest in having the corporation file either a petition for reorganization or a petition in bankruptcy based on that allegation. There may, however, be a basis for stockholders opposing on behalf of the corporation the filing of an involuntary petition. Such a right has been recognized under general equitable principles. See *Zeitinger* v. *Hardgardine-McKittrick Dry Goods Company*, 244 Fed. 799 (C. C. A. 8), certiorari denied 245 U. S. 667; *Cf. New England Coal & Coke Co.* v. *Rutland R. R. Co.*, 143 F. (2d) 179 (C. C. A. 2).

[4] In the different context of Section 11 of the Public Utility Holding Company Act of 1935, the Commission has held improper a stockholder's attempt to file derivatively on behalf of his corporation a plan under Section 11 (e) to comply with Section 11 (b). However, the effect of this holding is to leave the stockholder free to oppose plans filed by the company; and in default of a satisfactory voluntary plan, the stockholder may ultimately (dependent upon initia-

subsequently noted we believe no such inconsistency exists.

To the extent that our argument rests upon the reasoning of the majority of the court below we shall not restate it here. And, beause we are concerned with the broad aspects of the question presented, we express no views as to whether the petitioning stockholders in this case are entitled to the relief sought. On this aspect of the problem we believe it is sufficient to observe that the majority and minority of the court below agreed that the petitioning stockholders had alleged sufficient facts to support a complaint for equitable relief. Their difference was as to whether Chapter X is an appropriate vehicle to provide such relief. The parties on the petition for certiorari have argued at some length whether in fact grounds for equitable relief exist and also whether reorganization is possible. We have not concerned ourselves with either of these issues but have confined ourselves to the issue remaining on the assumption that the court either will refuse to examine the allegations of fraud and misconduct, or on examination will find them adequate, and on the further assumption that the question of the possibility of reorganization in Chapter X will be left for findings by the District Court in the event of affirm-

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tion of appropriate proceedings by the Commission) propose a plan which, if approved by the Commission, may be enforced by a district court under Section 11 (d). See *Republic Service Corporation*, Holding Company Act Release No. 3513, May 9, 1942.

ance of the decision of the Circuit Court of Appeals.

This memorandum is therefore limited to the discussion of two considerations: first, the relevance in the context of Chapter X of the traditional equitable principles under which stockholders are sometimes permitted to take legal action on behalf of their corporation, and second, the limitations and safeguards necessary to prevent possible abuse by stockholders of the right to file a derivative petition.

2. *The need for equitable relief.*—The derivative suit is an equitable device which, in effect, telescopes into a single proceeding the stockholder's equitable right to have a corporate claim, or defense, asserted against a third party, and the assertion of the corporation's claim or defense. To avoid the circuity of action and delay which would be incident to requiring a separate proceeding by the stockholder to have a receiver appointed or otherwise to displace the management, followed by another proceeding in which the corporate claim or defense is asserted, the complaining stockholder is permitted to act as a sort of self-appointed guardian *ad litem* for the corporation,[5] and thus to assert the corporate claim or defense directly against the third party—provided, of

[5] See *Hawes* v. *Oakland*, 104 U. S. 450; SEC Report on Protective and Reorganization Committees, Part I, 691–706; Simpson, *Fifty Years of Equity*, 50 Harv. L. Rev. 171, 190–191 (1936). For cases characterizing the complaining stock-

course, that certain requirements are met, which are, *inter alia,* designed to relieve the courts from having to settle mere disputes of business policy concerning corporate litigation.

The importance of this stockholder's right has been emphasized by the growth of the modern corporation, the increasingly widespread public ownership of stocks, and the development of voting trusts, holding companies, non-voting stocks, proxies, and other devices designed to separate stock ownership from corporate control.[6] These devices have generated conflicts of interest between stockholders and management, and have sometimes tended to make directors and officers more representative of powerful creditor groups than of their equitable cestuis que trust, the stockholders.[7]

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holder as a guardian *ad litem*, see *Whitten* v. *Dabney*, 171 Cal. 621, 630; 154 P. 312, 316; *Denicke* v. *Anglo California Nat. Bank*, 141 F. (2d) 285, 288 (C. C. A. 9).

[6] See Report on Protective and Reorganization Committees, Part VIII, pp. 184, 185; T. N. E. C. Monograph No. 29, *The Distribution of Ownership in the 200 Largest NonFinancial Corporations;* No. 30, *Survey of Shareholdings in 1710 Corporations with Securities Listed on a National Securities Exchange;* No. 11, *Bureaucracy and Trusteeship in Large Corporations;* Berle and Means, *The Modern Corporation and Private Property;* Bonbright and Means, *The Holding Company.*

[7] As the President stated in his Message to Congress of April 29, 1938—

"* * * industrial empire building, unfortunately, has evolved into banker control of industry. We oppose that.

"Such control does not offer safety for the investing public. Investment judgment requires the disinterested appraisal of

When the need arises for reorganization of the modern corporation, the divergence of the interests of management and stockholders may become acute, with unfortunate consequences to the widely scattered public stockholders. As one student of reorganization practice has stated:

> But to say that stockholders are represented by their directors in a reorganization is to forget that in reorganization "the corporate structure or entity * * * becomes diaphanous, and the stockholders emerge as the real parties in interest." It is no longer a matter of corporate business. It is a question of class against class, and a group struggle within a class. The directors were not elected to conduct such business. * * * practically it would seem that stockholders are often inadequately represented by directors and officers who may be bondholders, or associated with bondholders, or desire to be continued in office by the new stockholders. One example should illustrate this clearly. Under § 77B of the Bankruptcy Act the stockholders were given a great deal of power if insolvency was not found, or if the judge did not find that they would be unaffected by the plan. Would any one urge that the proper representatives in such a case should

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other people's management. It becomes blurred and distorted if it is combined with the conflicting duty of controlling the management it is supposed to judge." S. Doc. 173, 75th Cong., 3d Sess., reprinted in Final Report and Recommendations of the T. N. E. C., p. 11, at p. 13.

> be the directors who may honestly believe the corporation to be insolvent, and possibly not being more than nominal stockholders themselves, might have no further interest in protecting the rights of the stockholders? (Moore, *Bankruptcy Manual*, 1939, p. 542.)

The problems faced by public investors as a result of conflicting and overlapping interests as they impinge upon corporate management, indenture trustees and other fiduciaries have been a focal point of much of the recent federal legislation for the protection of investors, including the corporate reorganization provisions of the Bankruptcy Act. They have led, among other things, to express statutory provisions designed to eliminate conflicts of interest and provide for action by a disinterested trustee or by an administrative agency with affirmative responsibilities for representing interests of investors who may not otherwise be adequately represented.[8] These new remedies heve been fashioned largely because the traditional equitable remedies have proved inadequate to deal with the complexities of modern corporate organization. They were not, however, intended to eliminate the possibility of invoking traditional equitable remedies where in fact adapted to protection of the substantive rights involved. For, as this Court has stated, " 'courts of bankruptcy are essentially courts of equity, and

[8] See H. Rep. 1409, 75th Cong., 1st sess., pp. 37–38, 42–44, 47–48; S. Rep. 1916, 75th Cong., 3d sess., pp. 21, 22.

their proceedings inherently proceedings in equity' * * * at least in the sense that in the exercise of the jurisdiction conferred upon it by the Act, it applies the principles and rules of equity jurisprudence." *Pepper* v. *Litton,* 308 U. S. 295, 304; see *Taylor* v. *Standard Gas & Electric Company,* 306 U. S. 307, 322.[9]

The stockholders' derivative right serves as an instrument of self-help, which can appropriately be assimilated into the reorganization machinery if properly circumscribed by available safeguards against abuse. Just as stockholders have, under certain circumstances, the right to insist that the management institute proceedings to wind up their corporation (*Securities and Exchange Commission* v. *Fiscal Fund, Inc.,* 48 F. Supp. 712 (D. Del. 1943); *Kroger* v. *Jaburg,* 231 App. Div. 641, 248 N. Y. S. 387 (1st Dept. 1931); *Miner* v. *Belle Isle Ice Co.,* 93 Mich. 97, 53 N. W. 218 (1892). *Cf. Tower Hill-Connellsville Coke Co.* v. *Piedmont Coal Co.,* 64 F. (2d) 817 (C. C. A. 4), certiorari denied, 290 U. S. 675), so, as a corollary, in a proper case they would appear to have a right to demand that the management institute reorganization proceedings when the corporation is in need of financial rehabilitation. *Cf. New England Coal & Coke Co.* v. *Rutland R. R. Co.,* 143 F. (2d)

[9] In *Taylor* v. *Standard Gas & Electric Company,* the bankruptcy reorganization court employed its equitable powers to protect public preferred stockholders against the efforts of a creditor-management to effect an unfair plan.

179 (C. C. A. 2). If, in such a case, the management acts in collusion with dominant creditor interests, even to the point of assenting to a liquidation that will wipe out the stockholders' interests, stockholders may ask a court of equity to aid them to correct the management's fraud or bad faith. See *Lebold* v. *Inland Steel Co.*, 125 F. (2d) 369 (C. C. A. 7); *Jacobus* v. *Diamond Soda Water Mfg. Co.*, 88 N. Y. S. 302; *Whitney* v. *Hazzard*, 18 S. D. 490, 101 N. W. 346.

However, on the allegations of the present case, such a suit in equity would seem to be both inadequate and circuitous. If, as the stockholders allege, they have an equity which can be salvaged in a reorganization, and if also (as they must show to maintain their derivative proceeding) Chapter X is better adapted to salvaging their interest than the state court foreclosure proceeding, then they must ultimately invoke the jurisdiction of the bankruptcy court in order to obtain complete relief. A holding that they may not apply directly to the bankruptcy court by the filing of a derivative petition leaves as an alternative only a cumbersome and circuitous procedure. It would be necessary for them to obtain an injunction halting the dismembering of the corporation through further steps by way of foreclosure and to obtain a decree in the nature of a mandatory injunction requiring the directors to perform their fiduciary obligation by filing the traditional debtor reorgan-

ization petition under Chapter X. As a consequence, the necessary issues would have to be tried in two courts, the equity court and the bankruptcy court, and some of the same issues would have to be litigated in both courts. Thus, in the equity proceeding, the stockholders would have to establish (1) that reorganization is needed; (2) that they, the stockholders, have an equity in the corporation which is threatened with impairment or destruction by the action taken or acquiesced in by the board of directors (here surrender of the property to the bondholders); (3) that the decision of the management not to institute reorganization proceedings is motivated by fraud or bad faith rather than the exercise of business judgment; and (4) that the complaining stockholders have filed their suit in good faith and not for the purpose of harassing or otherwise injuring the corporation. If the stockholders sustain that burden in the equity court and in all the appellate courts to which the creditor-management interests might carry the litigation, they will then find themselves only at threshold of proceedings in the Chapter X court wherein sooner or later there must be a retrial of the first two issues, those as to the need for reorganization and as to the solvency or insolvency of the corporation.[10]

[10] The decision of the Chapter X court on the question of insolvency if made early in the proceeding, need not, and probably should not be, at this stage, the type of final determination which is conclusive at later stages of the proceeding by operation of Section 145.

The Bankruptcy court would determine these issues *de novo,* considering the condition of the corporation as of the time the reorganization petition is filed rather than the time when the decree was issued by the court of equity compelling the board of directors to file the petition. To limit stockholders to such expensive and dilatory procedure as their only protection from a creditor-dominated management would amount in practical effect to affording them no relief at all against inequitable deprivation of the protection designed to be afforded by Chapter X. Stockholders would thus be limited to whatever protection the state courts may afford against inequitable foreclosures. They would not obtain protection against the very inadequacies of the equity receivership as a vehicle for reorganization which led to the adoption of the bankruptcy reorganization statutes.

The Chapter X court has adequate facilities in the exercise of its statutory and inherent equitable powers to deal with all the issues that would be initially presented to an equity court in a stockholders' derivative suit. For the reasons we have suggested, it is consonant with the purposes of Chapter X that the equitable remedy of the stockholders' derivative suit should, in a proper case and subject to adequate safeguards, be made available in the form of a stockholders' derivative petition for reorganization.

3. *Necessary limitations and safeguards.*—We have adverted generally to abuses which might flow from extension of the stockholders' derivative remedy to the reorganization process. Since a decision in this case of first impression will, of course, be a guide to stockholders faced with similar problems in the future as well as to reorganization courts when they are presented with the problem, we desire to indicate what these potential abuses may be and how the reorganization courts can cope with them.

One traditional limitation upon the availability of derivative actions is that the courts will not concern themselves with what is nothing more than a dispute as to the business judgment of the management regarding the desirability of instituting an action or interposing a defense. *Hawes v. Oakland,* 104 U. S. 450, 460. This limitation is, of course, applicable to a derivative petition under Chapter X and we believe is given adequate recognition in the majority opinion of the court below (R. 120–122). It will be noted that the petitioning stockholders had shown both an alignment of the management with the interest of creditors and the pendency of uncontested foreclosure proceedings which would lead to a complete elimination of any stockholders' interest. When to this is added the further allegation that the stockholders had an equity which could be salvaged through the processes of Chapter X, the

stockholders present the typical issue which courts of equity have always recognized as a basis for a derivative suit—a clear breach of duty to the detriment of the corporation and the petitioning stockholders' interest therein.[11]

Recognition in proper circumstances of the right of stockholders to invoke Chapter X on behalf of their corporation does not mean that this relief will be available on insubstantial grounds. In fact, the basis for a derivative petition filed by a stockholder would necessarily be even more limited than the basis for the filing of an involuntary petition by creditors. Thus, the stockholder must allege the existence of an equity; otherwise he has no standing to complain of the failure of his management to file a petition.[12] This precludes the filing of a derivative stockholders' petition based upon allegations of insolvency in the bankruptcy sense where the corporation is able to meet maturing obligations. The further necessity of meeting the "good faith" requirement obliges the petitioning stockholder to satisfy the reorganization judge that there is a reasonable possibility of reorganization and if a prior proceeding is pending that it will not best

[11] As stated above, we do not address ourselves to the arguments of petitioner and respondent as to whether these further allegations were or can be sustained.

[12] *Falvey* v. *Foreman-State National Bank*, 101 F. (2d) 409 (C. C. A. 7), certiorari denied, 307 U. S. 632; *Campbell* v. *Anniston Office Bldg. Co.*, 73 F. (2d) 789 (C. C. A. 5); and see Note, 38 Mich L. Rev. 96 (1939).

subserve the interests of stockholders.[13] In the light of these requirements there is little danger of improvident approval of derivative petitions, provided a preliminary hearing is held.

We believe that a preliminary hearing is necessary in every case before the court approves a

[13] *Marine Harbor Properties* v. *Manufacturers Trust Co.*, 317 U. S. 78. The petitioners cite the *Marine Harbor* case as conclusive against the allowance of a petition here. However, the traditional state court equity foreclosure proceeding is a far less adequate vehicle for the effectuation of a "fair and equitable" plan of reorganization than the New York Schackno Act proceeding which this Court considered in that case. Added to the question of whether the foreclosure court has power to supervise the plan is the problem of raising cash to pay dissenters—a problem which has resulted in low bids and a judicial attempt to reconcile considerations of fairness with the necessities of reorganizers by first developing an "upset price" technique and then acquiescing in any price which is not so inadequate as to shock the conscience of the court. Finally, there are the further inadequacies which result from insider control of the reorganization machinery. See S. E. C. Report on Protective and Reorganization Committees, Part VIII, pp. 10–22; Katz, *The Protection of Minority Bondholders in Foreclosure and Receivership*, 3 U. of Chi. Law Rev. 517 (1936).

Stockholders filing a derivative petition for reorganization under Chapter X, where, as here, the directors are not contesting a state court foreclosure proceeding, may well complain that the rudimentary valuation technique used in the state court proceeding to determine the upset price may result in the elimination of an equity which could be salvaged by application of the valuation procedure employed in Chapter X. Cf. *First National Bank* v. *Bryn Mawr Beach Building Corp.*, 365 Ill. 409, 425, 6 N.E. (2d) 654, 662 (1937) with *Consolidated Rock Products Company* v. *DuBois*, 312 U. S. 510, 525–526.

derivative petition. This is a procedural precaution which is not articulated in the opinions of the court below and which was not followed by the district court in the instant case. Where stockholders assert the right to file a voluntary petition derivatively on behalf of their corporation, their action in so doing is of course not comparable to the filing of such a petition by the management accompanied as it would be by the usual indicia of at least prima facie authority to act for the corporation. In the latter cases *ex parte* approval of the petition is appropriate and is authorized by Section 141 provided the judge is "satisfied" that the petition is duly filed. Since, under Section 156, approval of the petition may be accompanied by immediate appointment of a trustee, and must be so accompanied if the indebtedness exceeds $250,000, such *ex parte* procedure seems manifestly inappropriate in the case of a derivative petition, which of necessity shows on its face the existence of a controversy between the stockholders and the management and thereby presents an issue requiring answer and hearing before taking the drastic step of approving the petition.

In the instant case the existence of foreclosure proceedings prevented the mere approval of the petition from having any material effect upon the credit of the debtor and, the indebtedness being less than $250,000, the court did not see fit to

appoint a trustee at the time when the derivative petition was first approved. Nevertheless, to avoid the possibility of injurious consequences from the improvident approval of a derivative petition upon a mere *ex parte* application, we believe that the proper practice would be to allow opportunity for answer and hearing in every case before approval of such a petition is granted.[14]

CONCLUSION

It is submitted that in appropriate circumstances, and subject to proper safeguards, a peti-

[14] This, of course, would not exclude an *ex parte* restraining order or even in extraordinary circumstances the *ex parte* appointment of a receiver to prevent irreparable injury before the court had an opportunity to determine the propriety of approving the petition. In this instance the petition was filed in the corporate name and signed in the name of the corporation by respondent Gurney, but was accompanied by an affidavit setting forth the reasons why respondent as a stockholder of the debtor claimed a derivative right to file on its behalf. (R. 1–9). We believe it would have been better practice for the petitioning stockholder to have filed his petition in such form that it would appear on the face of the petition rather than the supporting affidavit, that the petition was filed as a derivative action. However, the court was not in fact misled. Statements of counsel at the *ex parte* hearing called the court's attention to the facts in the affidavit indicating that "the corporation as such had taken no action authorizing the filing of the petition." (R. 92). At the conclusion of the *ex parte* hearing, the judge approved the petition and issued an injunction, although expressly stating that he was leaving open the issue as to the right of the stockholder to file the petition and other pertinent questions.

tion for reorganization under Chapter X may be filed on behalf of a debtor corporation by a stockholder asserting a derivative right.

Respectfully submitted.

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